Regional REIT

FY19 results

FY19 momentum and COVID-19 defences

Regional REIT's (RGL) results for the year to 31 December 2019 (FY19) confirmed its strategic and operational progress, with the financial results in line with expectations and the Q419 DPS paid as planned. Positive momentum in regional office and light industrial markets continued into FY20, but was punctuated by COVID-19. However, the portfolio is highly diversified and Q2 rent collection experience is encouraging, supported by an integrated asset management platform. The management team is experienced, borrowings are secure, and liquidity strong.

Year end	Net rental income (£m)	Adjusted earnings (£m)	Adjusted EPS* (p)	EPRA NAV*/ share (p)	DPS (p)	P/NAV (x)	Yield (%)
12/16	38.1	21.3	7.8	106.9	7.65	0.65	10.9
12/17	45.8	25.6	8.6	105.9	7.85	0.66	11.2
12/18	54.4	27.9	7.5	115.5	8.05	0.61	11.5
12/19	55.0	31.0	7.8	112.7	8.25	0.62	11.8

Note: Adjusted earnings exclude revaluation movements, gains/losses on disposal, and other non-recurring items, and unlike EPRA earnings also exclude performance fees. *Fully diluted.

Diversified tenant base and robust Q2 rent collection

As at 6 April 2020, 81.6% of Q2 rents invoiced had been collected (an increase from 68.2% as reported in the 31 March trading update), a modest drop on the same point in FY19 (83.1%) and supported by an integrated management approach that allows RGL to stay close to tenants. Tenants agreeing to switch to monthly payments represented an additional 4.8% of invoiced rents and RGL said that it expects to receive more than 90% of invoiced rents in the near-term. The tenant base is highly diversified and the experienced management team has worked together for a long time including through previous downcycles. Borrowings are secure with no near-term maturities and liquidity is strong.

FY19 results in line

Driven mainly by net acquisitions, the portfolio increased 9.7% to £788m (94% regional office/light industrial). Supported by a growing rent roll, robust occupancy and lower debt costs, adjusted earnings increased 10.9% to £31m and adjusted EPS by 3.7% to 7.8p. The previously declared Q419 DPS, taking the annual total to 8.25p, was paid in early April. The like-for-like value of the core office and industrial assets (94% by value) increased by 1.4% and, including retail, the overall portfolio value was down an underlying 0.1%. EPRA NAV per share fell 2.4% to 112.7p. LTV at c 39% remains within the 40% target. Given sector-wide uncertainties, we have temporarily withdrawn our forecasts, but note that FY19 net acquisitions will contribute for a full year in FY20 with continuing asset management opportunities.

Valuation: Strong income focus remains

RGL's highly diversified, income-led approach has delivered an average annual total return of 9.0% since IPO. The trailing dividend yield is close to 12% and the discount to end-FY19 NAV almost 40%. It is too early to assess the impact of COVID-19, but RGL remains committed to paying regular quarterly dividends, subject to market and trading performance and REIT guidelines.

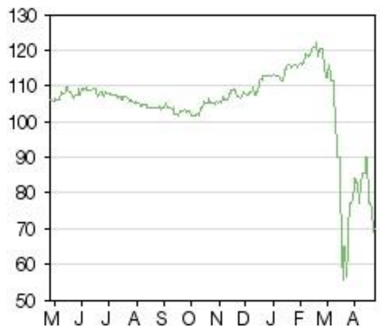
Real estate

24 April 2020

Price	**70p**
Market cap	**£302m**

Net debt (£m) at 31 December 2019	306.8
Net LTV at 31 Dec.2019	38.9%
Shares in issue	431.5m
Free float	100%
Code	RGL
Primary exchange	LSE
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	23.4	(39.6)	(33.5)
Rel (local)	5.0	(21.4)	(14.6)
52-week high/low		122.4p	55.8p

Business description

Regional REIT owns a highly diversified commercial property portfolio of predominantly offices and light industrial units located in the regional centres of the UK. It is actively managed and targets a total shareholder return of at least 10% with a strong focus on income.

Next event

2020 AGM	Date to be confirmed
Q120 trading update	21 May 2020

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Edison profile page

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COVID-19 update in detail

2019 was another active year for RGL, delivering further growth in the portfolio, part-funded by the £62.5m (before costs) equity capital increase in July 2019, in rent roll, and in underlying earnings. Total DPS for the year increased (by 2.5%), as it has in each of the four years since IPO.

Before discussing the FY19 results in more detail, we provide an update on the COVID-19 impact, and RGL's preparedness and responses.

Robust rent collection…

As at 6 April 2020, 81.6% of rents invoiced had been collected (an increase from 68.2% as reported in the 31 March trading update). The drop in collections at the same point in FY19 (83.1%) is relatively modest. Tenants who have agreed to switch to monthly payments represent an additional 4.8% of invoiced rents and RGL said that it expected a further 2.3% of rents due to be settled within seven days. Overall, RGL said that it was expecting to receive more than 90% of invoiced rents in the near-term and is hopeful of receiving all agreed rents by mid-year.

…supported by integrated asset management

RGL points to the granular, fully integrated asset management approach employed by the external asset manager, London & Scottish Property Investment Management (LSPIM), which helps it to stay close to tenants, providing useful support, and is likely to assist the company in optimising occupancy/rental collection during this crisis. LSPIM is responsible for the day-to-day management of the asset and debt portfolios, and operates from its base in Glasgow with a regional office network in Leeds, Manchester and London. The senior management team has worked together for a long time and has experience of managing portfolios for cash in downcycles.

Alongside LSPIM, Toscafund Asset Management (Toscafund) is the investment manager for RGL, responsible for the management functions of the company. Recognising the contribution the asset and investment managers to RGL's performance and the importance of providing continuity of management, especially at this challenging time, it has been agreed with the company that the management agreements will remain in place beyond the scheduled expiry later in 2020, until November 2023.

Portfolio diversification mitigates income risks

Portfolio diversification, by geography, property and individual occupiers (as well as the industries in which they operate) is a key element of the company's strategy to mitigate the cyclical risks to income that are inherent in the commercial property sector and that have been brought rapidly to the fore by COVID-19. As at 31 December 2019, the portfolio comprised 160 properties with 904 tenants (the largest representing 2.5% of rent roll). Around 41% of the tenants are multinational or FTSE 350 and above sized companies, and c 51% of tenants provide services that are classified as essential in the government's COVID-19 lockdown guidance. Around 94% of the portfolio by value represents office and light industrial units located in the regional centres of the UK outside of the M25 motorway, market segments that were continuing to benefit from increasing occupational demand, rising rents and positive supply-demand fundamentals ahead of the COVID-19 crisis (see below).

Secure funding with good liquidity

Significant refinancing activity, particularly over the past year, has increased the amount of available funding, while rationalising the number of facilities has increased average debt maturity and lowered the average cost. From a peak of c 49% in 2017 immediately after the Conygar acquisition, loan to value (LTV) has been steadily reduced in line with the group's medium-term target of c 40%.

At 30 December 2019 (FY19), RGL had debt facilities of c £372m (including unamortised debt arrangement costs), of which c £344m was drawn and outstanding. Allowing for c £37m of cash, net debt was c £307m and the LTV was 38.9%. The weighted average term to maturity was 7.3 years with no near-term maturities and an average cost (including hedging costs) of 3.5% pa. Since end-FY19, RGL has drawn down the available funding on the Santander and Royal Bank of Scotland facilities, taking total gross borrowing at 31 March 2020 to £369.1m and increasing the cash balance to £69.1m. Based on the end-FY19 gross property asset value, the 31 March 2020 LTV remained at c 39%. Allowing for the unsecured Retail Eligible Bond debt, the end-FY19 LTV ratios on the secured debt facilities were mostly below the group average LTV.

RGL has a target that at least 90% of the loan portfolio is hedged using fixed-rate facilities or interest rate swaps, and at end-FY19 the portfolio was more than 100% hedged.

Exhibit 1: Summary of debt portfolio at 31 December 2019

	Original facility (£m)	Outstanding (£m)*	Maturity	Gross loan to value	Interest terms
Royal Bank of Scotland	55.0	48.6	Jun-24	39.8%	Libor + 2.15%
Scottish Widows & Aviva	165.0	165.0	Dec-27	45.1%	3.28% fixed
Scottish Widows & Aviva	36.0	36.0	Dec-28	38.9%	3.37% fixed
Santander	65.9	44.4	Jun-29	26.4%	Libor + 2.20%
Total secured facilities	**321.9**	**294.0**			
Retail Eligible Bond	50.0	50.0	Aug-24	N/A	4.5% fixed
Total facilities	**371.9**	**344.0**			

Source: Regional REIT. Note: *Outstanding debt includes unamortised loan arrangement fees.

Each of the secured debt facilities has its own distinct covenants, which generally include historic interest cover (tested quarterly), LTV cover (tested annually), and debt service cover (tested quarterly). RGL was in compliance with all of these throughout FY19 and expects the same at 31 March 2020 (Q120) and says that at the end of the year had substantial borrowing headroom in relation to the covenants. Depending on rent collections the rent cover position in Q220 may be more challenging but RGL says that it enjoys strong and close relationships with its lenders and that it expects no issues to arise.

Market background and portfolio update

Positive 2019 fundamentals carried into 2020

Regional offices represented 79.9% of the 31 December 2019 portfolio by value and light industrial assets 13.7%, with retail assets accounting for just 5%. During 2019 and early 2020, supply-demand fundamentals for both regional office and industrial sectors remained positive with robust occupier demand, despite Brexit uncertainty and some weakening in overall economic growth prospects and limited new supply. In the investment market, UK-wide commercial real estate investment volumes weakened in H119, although there are some signs that the impact in the regions was more muted than for London. Overall UK volumes were lower during 2019 (13% below the five-year average according to Lambert Smith Hampton), but accelerated in the second half of the year, and in the regions outside London, the fourth quarter pick-up in volumes was notable.

Regional office rents continued to experience upward pressure, contributing to an ungeared total property return of 8.6% according to CBRE, outperforming the central London total return of 5.8%, as has been the case over the past four years.

Occupier demand in the industrial market softened in 2019, but remained positive and sufficient to absorb new supply, supporting continuing rental growth but at a slower pace than in 2018.

Robust occupancy and achieved rental growth

In 2019, RGL's annual gross contracted rent roll increased from £59.7m to £64.3m including a c £6.3m net addition from acquisitions and disposals. Disposals, primarily in H119, amounted to £24.3m (net of costs), reflecting an average net initial yield of 6.8% and achieving an average uplift on the end-2018 valuation of 10.3%. Acquisitions, primarily in H219, amounted to £87.1m (before costs), adding £8.0m to annualised gross contracted rental income and reflecting an average net initial yield of 8.6%. EPRA occupancy across the portfolio was flat at 89.4% (slightly up in industrial and slightly down in offices as two properties became vacant), but on a like-for-like basis was slightly lower at 88.1% compared with 89.6% at the end of 2018. Together with the reduction in contracted rents on the small retail exposure in the portfolio (5% by value) and partly offset by rent uplifts on leasing events, this explains the c £1.8m like-for-like reduction in contracted rent roll. Lease renewals for office and industrial assets achieved an uplift in gross rent roll of 9.8% on average, while 71 new lettings (356k sq ft) were completed, providing a gross rental income of £3.8m when fully occupied.

The portfolio value increased by 9.4% to £788m, primarily reflecting net acquisitions, but also including capital expenditure and a net negative unrealised valuation movement of £3.5m (including c £2.8m of property acquisition costs, mostly related to deployment of the proceeds of the July capital raise). The like-for-like value of the group's core office and industrial assets (93.6% by value) increased by 1.4% after adjusting for capital expenditure and disposals during the period. Including retail, the overall portfolio value was down an underlying 0.1%.

Too early to assess COVID-19 impacts

It remains too early to be able to assess the longer-term impact of COVID-19. In the near term, the focus is on optimising the collection of contracted rents while providing support to tenants where this is appropriate. The most obvious immediate effect is on cash flow, for which the strong cash position provides an immediate cushion. Depending on the extent and duration of the pandemic, the longer-term impact on tenants and the broader economy, and the implications of this for occupancy and contracted rents, will become clearer. A swift and significant rebound in activity following the period of lockdown is to be hoped for but, despite significant efforts by government and the central banks to support economies, the occupational market seems likely to be softer than before the pandemic. Positively, in contrast to the last major economic and commercial property downturn in 2018, interest rates remain low and rents have not risen so far as to encourage widespread speculative development activity. RGL's focus on the regional property and light industrial sectors and its highly diversified tenant base are positive factors.

The potential impact of COVID-19 on property valuations and NAV is similarly unclear at this stage, although RGL's Q120 trading update scheduled for 21 May 2020 may provide an update on the immediate impact on its own property valuations. Given the lack of representative transactions taking place from which to extract pricing evidence, a statement highlighting material uncertainty has recently introduced by external valuers across the sector.

Financials and valuation

In Exhibit 2 we summarise the FY19 financial performance. Net rental income and underlying earnings were slightly ahead of our last published forecasts and EPRA NAV per share slightly below, but consistent with the portfolio valuation update contained in the late-January trading update.

Exhibit 2: Summary of FY19 financial performance

	FY19			FY18			FY19/FY18
£m unless stated otherwise	**IFRS**	**Adj.**	**Adj. earnings**	**IFRS**	**Adj.**	**Adj. earnings**	**Adj. earnings**
Rental income	**75.6**		**75.6**	**74.0**		**74.0**	**2.2%**
Property costs	(20.7)		(20.7)	(19.6)		(19.6)	5.3%
Net rental income	**55.0**		**55.0**	**54.4**		**54.4**	**1.1%**
Administrative & other expenses	(10.9)		(10.9)	(10.5)		(10.5)	3.5%
Performance fee	0.0		0.0	(7.0)	7.0	0.0	
Operating profit before gains/(losses) on property	**44.1**	**0.0**	**44.1**	**36.8**	**7.0**	**43.8**	**0.5%**
Gain on disposal of investment property	1.7	(1.7)	0.0	23.1	(23.1)	0.0	
Change in fair value of investment property	(3.5)	3.5	0.0	23.9	(23.9)	0.0	
Amortisation of right of use asset	(0.2)		(0.2)				
Operating profit	**42.0**	**1.9**	**43.9**	**83.8**	**(40.0)**	**43.8**	**0.1%**
Net finance expense	(13.7)	0.5	(13.2)	(15.7)	0.4	(15.3)	-13.4%
Impairment of goodwill/change in fair value of derivatives	(2.0)	2.0	0.0	(0.1)	0.1	(0.0)	
Profit before tax	**26.3**	**4.4**	**30.6**	**67.9**	**(39.4)**	**28.5**	**7.4%**
Tax	0.3	0.1	0.4	(0.6)	0.0	(0.6)	
Net profit	**26.5**	**4.5**	**31.0**	**67.4**	**(39.4)**	**27.9**	**10.9%**
Basic IFRS EPS (p)			6.6			18.1	
Diluted EPRA EPS (p)			7.8			5.6	38.6%
Diluted adjusted EPS			**7.8**			**7.5**	**3.7%**
DPS (p)			**8.25**			**8.05**	**2.5%**
Diluted EPRA NAV (p)			112.7			115.5	-2.4%
Investment properties			787.9			718.4	9.7%
Net LTV			38.9%			38.3%	

Source: Regional REIT data

The key features of earnings on an underlying basis were:

- Net rental income increased slightly to £55.0m, reflecting an increase in the portfolio size as well as achieved rental growth during the year, partly offset by increased non-recoverable property expenses.
- Administrative expenses increased with the growth in NAV, as well as some one-off fees (partly linked to the ZDP maturity) and underlying operating profit before realised and unrealised gains and losses on the property portfolio increased 0.5% to £44.1m. The EPRA cost ratio was 31.6% (including direct vacancy costs) compared with 40.1% in FY18 (or 28.6% excluding the FY19 performance fee accrual).
- Net finance expenses were lower, reflecting a reduction in both average borrowings and the average cost of debt. Of note was the February 2019 repayment at maturity of c £40m of 6.5% zero dividend preference shares. The 3.5% weighted average cost of debt at end-FY19 compared with 3.8% at end-FY18.
- Underlying profit before tax increased 7.4% and underlying net profit, including a small tax credit, increased by 10.9% to £30.6m. Underlying EPS, allowing for the increased number of shares in issue following the £62.5m (gross) equity capital increase in July 2019, increased 3.7% to 7.8p. With no performance fee adjustment in the year, there was no difference between underlying and EPRA earnings. DPS of 8.25p was 95% covered.
- Reported (IFRS) earnings include realised gains on property disposals (£1.7m), negative unrealised movements in property valuation (£3.5m, including £2.8m of acquisition costs written off), negative fair value changes to interest rate hedging instruments (£1.5m), impairment of goodwill (£0.6m), close-out costs on borrowings and derivatives (£0.5m) and a small (£0.1m) deferred tax charge.
- Including the above, the IFRS net profit was £26.5m and basic EPS was 6.6p.
- EPRA NAV per share reduced slightly to 112.7p (end-FY18: 115.5p) and including DPS paid the EPRA NAV total return was 4.7%. That brought the cumulative total since IPO in November 2015 to 43.0% or a compound annual average return of 9.0%. Dividends accounted for 70% of

the cumulative total return and an investment at IPO would have generated an IRR of more than 10%.

Given the immediate sector-wide uncertainty regarding cash flows, rental income and property valuations, we have temporarily withdrawn our forecasts and will seek to reinstate these as soon as a clearer picture emerges. In addition to our observations above regarding portfolio diversification, secure funding and a strong level of current liquidity, we would also note that net property acquisition activity in 2019 made only a partial contribution in the year. We estimate a potential further uplift to gross rental income of more than £1m in 2020. Additionally, the end-FY19 estimated rental value at full occupancy was £72.2m, well ahead of the £64.3m gross contracted rent roll, suggesting that there will be continuing opportunities to support income through continued active asset management even in a likely softer letting market.

Share price valuation

Given the sector-wide uncertainties, we are unable to provide a meaningful, forward-looking comparison with peers, but based on the FY19 DPS of 8.25p, RGL has a trailing dividend yield of c 11% and trades at a more than 30% discount to end-FY19 EPRA NAV per share. This valuation is clearly building in material sustained negative impacts from the COVID-19 crisis. We estimate that for the EPRA NAV per share to fall to the current share price (such that the share price would then represent 1.0x NAV), a c 23% reduction in the portfolio value would be required. As a result of the recent share price decline, the trailing dividend yield has increased from c 7.5% at the time of our November 2019 outlook note) and reflects sector-wide uncertainty about cash flows and future dividend pay-outs. At the current share price, a prospective 7.5% dividend yield would imply a reduced 5.25p DPS. If based on the FY19 income statement we estimate that this would be consistent with a c 12% reduction in the gross rental and other income (including service charge income) reported in the year and a full pay-out of the resulting adjusted earnings. Our analysis suggests that the same result could actually be achieved with a larger underlying reduction in rental income if allowance is made for the expected increased contribution to FY20 rental income from a full period contribution from the FY19 acquisitions and ongoing asset management initiatives.

Exhibit 3: Financial summary

Year end 31 December (£000's)	2016	2017	2018	2019
PROFIT & LOSS	**IFRS**	**IFRS**	**IFRS**	**IFRS**
Rental income	42,994	61,610	74,019	75,645
Non-recoverable property costs	(4,866)	(15,763)	(19,644)	(20,681)
Net rental income	38,128	45,847	54,375	54,964
Administrative expenses (excluding performance fees)	(7,968)	(7,819)	(10,540)	(10,904)
Performance fees	(249)	(1,610)	(7,046)	0
EBITDA	29,911	36,418	36,789	44,060
EPRA cost ratio	n.a	29.7%	40.1%	31.6%
EPRA cost ratio excluding performance fee	n.a	26.6%	28.6%	30.9%
Gain on disposal of investment properties	518	1,234	23,127	1,662
Change in fair value of investment properties	(6,751)	5,893	23,881	(3,513)
Change in fair value of right to use asset				(194)
Operating profit before financing costs	23,678	43,545	83,797	42,015
Exceptional items	0	0	0	0
Net finance expense	(8,629)	(14,513)	(15,715)	(13,725)
Net movement in the fair value of derivative financial investments and impairment of goodwill	(1,654)	(340)	(142)	(2,036)
Profit Before Tax	13,395	28,692	67,940	26,254
Tax	23	(1,632)	(567)	257
Profit After Tax (FRS 3)	13,418	27,060	67,373	26,511
Adjusted for the following:				
Net gain/(loss) on revaluation/disposal of investment properties	6,233	(7,127)	(47,008)	1,851
Net movement in the fair value of derivative financial investments	865	(407)	(459)	1,479
Other EPRA adjustments including deferred tax adjustment	557	4,488	987	1,146
EPRA earnings	21,073	24,014	20,893	30,987
Performance fees & exceptional items	249	1,610	7,046	0
Adjusted earnings	21,322	25,624	27,939	30,987
Period end number of shares (m)	274.2	372.8	372.8	431.5
Fully diluted average number of shares outstanding (m)	274.3	297.7	372.8	398.9
IFRS EPS - fully diluted (p)	4.9	9.1	18.1	6.6
Adjusted EPS, fully diluted (p)	7.8	8.6	7.5	7.8
EPRA EPS, fully diluted (p)	7.7	8.1	5.6	7.8
Dividend per share, declared basis (p)	7.65	7.85	8.05	8.25
Dividend cover	101.6%	109.7%	93.1%	94.2%
BALANCE SHEET				
Non-current assets	506,401	740,928	720,886	805,980
Investment properties	502,425	737,330	718,375	787,915
Other non-current assets	3,976	3,598	2,511	18,065
Current Assets	27,574	66,587	126,986	69,406
Other current assets	11,375	21,947	22,163	32,158
Cash and equivalents	16,199	44,640	104,823	37,248
Current Liabilities	(23,285)	(42,644)	(83,685)	(36,190)
Bank and loan borrowings - current	0	(400)	(40,216)	0
Other current liabilities	(23,285)	(42,244)	(43,469)	(36,190)
Non-current liabilities	(218,955)	(371,972)	(334,672)	(355,468)
Bank and loan borrowings - non-current	(217,442)	(371,220)	(334,335)	(337,142)
Other non-current liabilities	(1,513)	(752)	(337)	(18,326)
Net Assets	291,735	392,899	429,515	483,728
Derivative interest rate swaps & deferred tax liability	1,513	2,802	971	2,552
EPRA net assets	293,248	395,701	430,486	486,280
IFRS NAV per share (p)	106.4	105.4	115.2	112.1
Fully diluted EPRA NAV per share (p)	106.9	105.9	115.5	112.7
CASH FLOW				
Cash (used in)/generated from operations	31,434	40,251	38,817	26,022
Net finance expense	(6,626)	(9,167)	(11,923)	(12,748)
Tax paid	(1,715)	(236)	(1,467)	(839)
Net cash flow from operations	23,093	30,848	25,427	12,435
Net investment in investment properties	(99,286)	(8,267)	100,601	(25,623)
Acquisition of subsidiaries, net of cash acquired	(5,573)	(51,866)	(32,629)	(43,943)
Other investing activity	60	25	220	163
Net cash flow from investing activities	(104,799)	(60,108)	68,192	(69,403)
Equity dividends paid	(15,723)	(23,321)	(29,429)	(32,534)
Debt drawn/(repaid) - inc bonds and ZDP	91,417	13,921	(547)	(36,366)
Net equity issuance	0	71,256	(1,190)	60,503
Other financing activity	(1,744)	(4,155)	(2,270)	(2,210)
Net cash flow from financing activity	73,950	57,701	(33,436)	(10,607)
Net Cash Flow	(7,756)	28,441	60,183	(67,575)
Opening cash	23,955	16,199	44,640	104,823
Closing cash	16,199	44,640	104,823	37,248
Balance sheet debt	(217,442)	(371,620)	(374,551)	(337,142)
Unamortised debt costs	(2,618)	(4,843)	(5,752)	(6,858)
Closing net debt	(203,861)	(331,823)	(275,480)	(306,752)

Source: Regional REIT data

EDISON

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